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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 136

THE BADGER OIL COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

WALTER G. RUSSELL,
ROSS M. LAMBDIN,
GEO. S. MCCARTHY,
Counsel for Petitioner.

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vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Badger Oil Company, a corporation organized under the laws of the State of Texas, prays this Court for the issuance of a writ of certiorari to review the final judgment of the United States Circuit Court of Appeals for the Fifth Circuit, entered on the 8th day of April, A. D. 1941, affirming a decision of the United States Board of Tax Appeals.

Statement of the Matter Involved.

The matter involved herein is a question of the interpretation and application of the Revenue Laws of the United States and the Regulations thereunder with respect to the allowance of percentage depletion on the consideration of $305,000.00 received for the assignment of an oil and gas lease to the International Petroleum Corporation in 1935.

Petitioner in 1926 acquired an oil and gas lease and drilled and acquired thereon seven producing oil wells (R. 64 and R. 74). Subsequently, on April 17, 1934, it acquired from the land owners, the Lewises, the fee title to their 2,947.8 acre ranch, in Hutchinson County, Texas (R. 67), under which the petitioner's 1,321 acre oil and gas lease was located, together with their two-thirds remaining royalty or mineral interest in such lands which had never been separated from the fee (R. 67). In February, 1935, while the owner of the lease, the fee, and all the mineral interest in the oil in place, except the outstanding one-third royalty interest, the petitioner transferred by assignment its 1,321 acre oil and gas lease and executed a new lease to an additional 160 acres which had heretofore reverted to it (R. 65), receiving therefor a consideration of $305,000.00 in cash in 1935, exclusive of the cash consideration received for the sale of the personal property located on the leasehold estate (R. 65). The directors of petitioner were influenced in making the sale by their knowledge that the International Petroleum Corporation intended as soon as it became the owner to begin a large development of the property (R. 60-62). This intention was carried out and at the time of the hearing the purchaser had completed forty-two wells and had one well drilling (R. 61). The petitioner

would not have sold for the amount received if it had not anticipated a large return from its retained royalty interest (R. 61). Royalty oil and gas received from February 1, 1935, to November 1, 1939, amounted to $97,858.64 (R. 66).

Petitioner sought to deduct percentage depletion on the cash consideration of $305,000.00 thus received (R. 79). The Commissioner of Internal Revenue disallowed depletion on the cash consideration which had been deducted by petitioner on its 1935 income tax return and assessed a deficiency in income tax of $9,860.32 and an Excess Profits Tax of $3,585.57 (R. 13), the petitioner petitioned the Board of Tax Appeals for review (R. 41), the respondent answered (R. 17), hearing was had at Dallas, Texas (R. 1), and rehearing (R. 2), and opinion and findings of fact rendered by the Board of Tax Appeals (R. 32), affirming the Commissioner's disallowance of depletion, and petitioner filed its petition for review by the Honorable United States Circuit Court of Appeals for the Fifth Circuit (R. 41), and the Honorable Circuit Court of Appeals entered its decision affirming the decision of the Board of Tax Appeals on the 8th day of April, 1941 (R. 149).

The petitioner duly filed on the 28th day of April, 1941, within 21 days from such decision by the Circuit Court of Appeals, its petition for a rehearing by the Circuit Court of Appeals (R. 150), which petition was denied (R. 157), and petitioner filed its motion to stay mandate on the 19th day of May, 1941, and within ten days from the overruling of its petition for rehearing (R. 157), and the Honorable United States Circuit Court of Appeals for the Fifth Circuit issued its order staying mandate for thirty days from May 19, 1941, the date of its order (R. 159).

Basis of Jurisdiction.

The judgment sought to be reviewed is the judgment of the United States Circuit Court of Appeals for the Fifth Circuit rendered on the 8th day of April, 1941 (R. 149), affirming a judgment of the Board of Tax Appeals on a matter involving the revenue laws of the United States. The nature of the case is one involving the question whether petitioner is entitled to percentage depletion on a cash consideration received from the transfer of a part of its interest in oil in place and is explained in the preceding statement.

The opinion of the United States Circuit Court of Appeals for the Fifth Circuit filed on the 8th day of April, 1941 (R. 143), reflects the decision of said court to be that, although the taxpayer, being the fee owner of the land and owning a reversionary interest in the 7/8ths operating interest, and owning also the lease, retained an economic interest in the oil reserve, by virtue of the transaction, and that even though taxpayer after selling its lease, still had an interest in the oil reserve as successor in title of the lessor and as part owner of the reversion, it was nevertheless not entitled to deplete the cash consideration as a bonus as upon a lease, but is relegated to the position of a mere lessee selling its lease and reserving no interest in the property, although by privity of estate existing by virtue of the assignment of the lease, the assignee was obligated under the lease to pay as royalty a portion of all oil and gas produced to petitioner, assignee of lessor, for the life of the lease. Petition for rehearing was filed on the 28th day of April, 1941 (R. 150), and same was denied on the 10th day of May, 1941 (R. 157), and petition for writ of certiorari is presented herein on the 6th day of June, 1941.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as Amended by the Act of

February 13, 1925, C. 229, Section 1, 43 Stat. 938 (28 U. S. C. A. 347) (8 F. C. A. Title 28, Section 347), and under Section 641 (a) of the Internal Revenue Code (Feb. 26, 1926, c. 27, Sec. 1003 (a), 44 Stat. 110; June 7, 1934, c. 426, 48 St. 926) (26 U. S. C. A. Section 1141) (6 F. C. A. Section 641).

Question Presented.

The primary question presented is:

> Whether petitioner had and retained an interest, *i. e.*, a capital investment in oil and gas in place so as to entitle it to the percentage depletion allowance under Section 114 (b) 3 and 4 and Section 23 (m) of the Revenue Act of 1934 on $302,350.00 of the consideration of $305,000.00 received for the leasing transaction.

Reasons for Allowance of the Writ.

Reason 1.

The judgment and decision of the Circuit Court of Appeals that petitioner, "After selling outright for money its lease interest, still had an interest in the oil reserve as the successor in the title of lessor, but that is not the same thing as retaining a royalty in the transfer. His interest stood unmerged. He sold his lease interest without any reservation," when petitioner was the owner of all interests in the oil and gas in place save and except an outstanding one-third interest in the royalty and reversion, has decided a Federal question in a way probably in conflict with applicable decisions of this court, in *Palmer* v. *Bender*, 287 U. S. 551; *Wm. E. Herring* v. *Commissioner of Internal Revenue*, 293 U. S. 222; *Thomas* v. *Perkins*, 301 U. S. 655, *Guy T. Helvering, Commissioner*, v. *Bankline Oil Company*, 303 U. S. 362, and *Guy T. Helvering* v. *Thomas A. O'Donnell*, 303 U. S. 370.

The Circuit Court of Appeals bases its decision on *Commissioner* v. *Fleming,* 82 F. (2d) 324 and *Laird* v. *Commissioner,* 97 F. (2d) 730, also *Hammonds* v. *Commissioner,* 106 F. (2d) 420, all of which involve cases where the taxpayer had only a working interest in the property to start with and sold all of such interest. The royalty retained by petitioner in this case and the bonus received for the transfer is analogous to the overriding royalty retained by the Smitherman partnership in *Palmer* v. *Bender,* out of their working interest lease.

The Supreme Court in its decision in *Palmer* v. *Bender* calls attention to the fact that "The Government rests its case on this conclusion (the conclusion referred to being that the instruments were assignments of leases or sales of the leases for the stipulated consideration of bonus paid and royalties to be received). It concedes that if any *reversionary interest,* according to the common law, however small has been retained in the leased land by the two partnerships, the petitioner is entitled to the depletion allowances claimed, * * *."

In *Bankline Oil Company, Petitioner* v. *Commissioner of Internal Revenue, Respondent* (33 B. T. A. 910), the decision of the Board of Tax Appeals was reversed by the Ninth Circuit Court of Appeals (90 F. (2d) 899) and because of an asserted conflict with the principles applicable under decisions of the Supreme Court certiorari was granted there where the question was whether the holder of a favorable contract to purchase wet gas at the well had the economic interest necessary to entitle him to depletion; in *Helvering* v. *O'Donnell,* 303 U. S. 370, and *Helvering* v. *Elbe Oil Co.,* 303 U. S. 372, where the question was whether a share in the net profits from development and operation was such an interest was the point upon which certiorari was granted. In all the cases just named, a new situation

under the peculiar circumstances of each case as provided by statute, presented the question whether a depletable economic interest had been retained. Petitioner's case now presents an entirely new situation for application of the depletion statutes. Petitioner probably had such required retained interest. If it did, the Circuit Court erred in its decision, and such decision conflicts with applicable decision of the Court. So, there is probability of conflict with the applicable decisions of the Supreme Court justifying issuance of the writ of certiorari so that the question may be settled.

The Supreme Court has held that the language of the Statute is broad enough to permit a depletion allowance in every case where a taxpayer had acquired, by investment, an interest in the oil in place, and acquired, by legal relation, income derived from the extraction of oil, to which the taxpayer must look for the return of his capital. The Supreme Court has also stated that the right to depletion allowance does not depend upon the retention of ownership or special form of legal interest in the mineral content of the land, but upon his right to share in the oil produced. Thus, if he has an economical interest in the oil in place, he is entitled to the depletion allowance (*Palmer* v. *Bender, supra*).

Reason 2.

The Circuit Court of Appeals, in holding as it did in this case that petitioner was not entitled to percentage depletion on a cash payment received for the assignment of a part of petitioner's interest in the oil reserve, basing its decision as it did on the fact that the entire title to the minerals never vested in petitioner so that petitioner could not claim to hold a full lessor's interest, probably conflicts with applicable decisions of the Supreme Court, particularly with the decision in *Palmer* v. *Bender,* 287 U. S. 551,

53 S. Ct. 225, under the holding therein "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired by investment, any interest in the oil in place, and secures by any form of legal relationship income derived from the extraction of the oil, to which he must look for a return of his capital," and the decision in *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364, under the holding therein that the allowance for depletion is not made dependent upon the particular form of the taxpayer's interest in the property to be depleted.

For convenience, we may break up petitioner's interests, at the time of the transaction, into such elements as royalty rights, or as to the right to demand and receive payment of rentals in lieu of drilling operations, or as to its inchoate right to the reversion of the working interest transferred to its assignee, all of which interests petitioner had in the property, but actually all such elements at the time of the transfer to International Petroleum Corporation were, as to ownership, in petitioner to form "all the right, title, interest and claim" which petitioner had in and to the property, and represented petitioner's capital investment therein, and the Circuit Court held that petitioner "owning reversionary interests and accompanying royalty, and owning also this lease, chose to retain the former and sell the latter. It retained as vendee of the lessors an economic interest in the oil reserve;" and, as said in *Alexander* v. *Continental Petroleum Co.*, 63 F. (2d) 927: "We agree the transaction was a sale of leases. But it was not an end of the plaintiffs interest in the production of oil."

The record as to the transaction itself discloses that International Petroleum Corp., as lessee's assignee, was bound by acceptance of the assignment to pay to petitioner, lessor's assignee, the royalty provided in the lease out of all oil produced from the lease by International Petroleum

Corporation, *Leonard* v. *Prater*, Com. App. 1931, 36 S. W. (2d) 216, 217, 86 A. L. R. 499. The legal relationship which secured income from the production of oil was thus secured by the petitioner by virtue of the transaction, which this Court in *Palmer* v. *Bender, supra*, said the statute provided for.

The decision of the Circuit Court also probably conflicts with the applicable principles of decision of the Supreme Court in the following cases: *Works* v. *United States ex rel. Mosier*, 261 U. S. 252; *Murphy Oil Co.* v. *Burnett*, 287 U. S. 299; *Palmer* v. *Bender*, 287 U. S. 551; *Wm. E. Herring* v. *Commissioner of Internal Revenue*, 293 U. S. 222; *Thomas* v. *Perkins*, 301 U. S. 655; *Guy T. Helvering, Commissioner*, v. *Bankline Oil Company*, 303 U. S. 362; *Guy T. Helvering* v. *Thomas A. O'Donnell*, 303 U. S. 370; *Anderson-Pritchard* v. *Helvering*, 310 U. S. 404, 60 S. Ct. 952. It also conflicts with the decision by our Texas Courts in *Jensen* v. *Wilkinson et al.*, 133 S. W. (2nd) 982, on the question of retained taxable interest, that court holding a reversionary interest in a working interest to be a taxable interest in land.

Reason 3.

The judgment and decision of the Circuit Court of Appeals that "none of that royalty was paid in advance by International Petroleum Corporation in this purchase. It all remained to be paid. There is no room to say that the money in this transaction was paid as advance royalty and hence is depletable income arising from operation of oil wells," when petitioner, before making the lease transaction, was the land owner, the oil developer and operator and the owner of the royalty and reversion rights, all of the possible interests being merged in one common ownership, except that of the outstanding one-third royalty and one-third reversion, and petitioner would not have sold for the

$305,000.00 consideration received if it had not anticipated a large return from its retained royalty interest, has decided a Federal question in a way probably in conflict with applicable decisions of this Court in *Works* v. *United States, ex rel. Mosier,* 261 U. S. 252; *Murphy Oil Company* v. *Burnett,* 287 U. S. 299; *Palmer* v. *Bender,* 287 U. S. 551; and *Wm. E. Herring* v. *Commissioner of Internal Revenue,* 293 U. S. 222. The royalty rate was already fixed in the instrument transferred and the cash consideration, a variable one depending upon the desirability of the privilege of entering upon the land for development purposes, paid by the International Petroleum Corporation, secured for that company desirable oil property and secured for the petitioner the just value of the use of its property, which the fixing of royalties by the Lewises in the original oil and gas lease, in advance, was not adapted to give, and as said in *Palmer* v. *Bender, supra.*

"Thus throughout their changing relationships * * * the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees were entitled to share in the oil produced. Production and sale of the oil produced would result in its depletion and also in a return of capital investment to the parties according to their respective interests."

Reason 4.

The decision and judgment of the Circuit Court of Appeals in refusing allowance of depletion to petitioner having a capital investment in the oil and gas in place constantly depleted by production under the lease assigned, the assignee thereof being contractually bound by acceptance of the assignment to account for a share of production, the

decision and judgment of the Circuit Court of Appeals being that such a transaction was a sale of a lease without any reservation and the consideration received was purchase money and that the taxpayer, after selling outright its lease interest, still had an interest in the oil reserve as successor in title of the lessor, but such a transaction was not the same thing as retaining a royalty in the transfer, has decided an important question of Federal law which has not been but should be settled by this Court. Many cases have decided that assignors of leases who retain no interest in the oil in place cannot deplete the cash received for the transfer as a bonus or advance royalty because of outright sale of all interests in the oil reserve, but no case has been found deciding whether one who has operated a lease as a lessee for a number of years, producing oil and gas, then acquires the fee and royalty together with the reversion all still attached to the fee, except as to a small outstanding royalty interest in third parties, and, who later assigns only the lease, has retained such an interest as to entitle him to depletion under an assignment of lease, the acceptance of which obligated the assignee to account to assignor for a portion of the production from the property throughout the life of the lease. The principles involved in this case will find frequent application in connection with the taxation of persons and corporations engaged in the oil industry. The question is one of general importance and to deny the taxpayer the right to deduct percentage depletion where he, as owner of the working interest subsequently acquires a fee and then disposes of the working interest, to secure income from operation of his land for oil and gas by another, leads to inconsistency in the application of the Internal Revenue laws.

Reason 5.

The decision and judgment of the Circuit Court of Appeals in the case has decided an important question of local law in a way probably in conflict with applicable local decision, in that the Circuit Court has failed to recognize and give effect to the rule of property established by the decision of the Courts of Texas holding the reversionary interest in the 7/8ths leasehold under oil and gas leases to be taxable interests in land, and when petitioner in this case transferred the 7/8ths operating interest, it retained the reversion therein, and had and retained a taxable interest in the very thing transferred.

Conclusion.

Wherefore, for the reasons herein advanced, it is respectfully submitted that the Supreme Court of the United States should exercise its jurisdiction to review by writ of certiorari the judgment of the Circuit Court of Appeals to the end that an important question of Federal Law involving the construction of a Federal statute and regulations thereunder relating to allowance of percentage depletion be settled, and an end be put to the probable conflict in the decisions of Circuit Courts of Appeals with applicable decisions of the Supreme Court.

Respectfully submitted,

WALTER G. RUSSELL,
ROSS M. LAMBDIN,
GEO. S. MCCARTHY.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Opinions of the Court Below.

The opinion of the Board of Tax Appeals is reported in 42 B. T. A. 521 and appears at Pages 32-39 of the Record, and its decision appears at Page 39 of the Record.

The reported opinion of the United States Circuit Court of Appeals, Fifth Circuit, rendered on April 8, 1941, appears in 118 F. (2d) 791, and appears at Page 143 of the Record, and the judgment of the Circuit Court appears at Page 149 of the Record.

Grounds on Which Jurisdiction is Invoked.

A statement of the grounds of jurisdiction is contained in the petition. The judgment of the United States Circuit Court of Appeals affirmed the decision of the Board of Tax Appeals. Such judgment of the Circuit Court of Appeals was entered on the 8th day of April, 1941 (R. 143). A petition for rehearing was filed April 28, 1941 (R. 150) and same was denied May 10, 1941 (R. 157). Petition for certiorari is presented herein on the 6th day of June, 1941. Jurisdiction is invoked under Section 240(a) of the Judicial Code as Amended by the Act of February 13, 1925, c. 229, Section 1, 43 Stat. 938 (28 U. S. C. A. 347) (8 F. C. A. Title 28, Section 347), and under Section 641 (a) of the Internal Revenue Code (Feb. 26, 1926, c. 27, Sec. 1003 (a), 44 Stat. 110; June 7, 1934, c. 426, 48 Stat. 926) (26 U. S. C. A. Sec. 1141) (6 F. C. A. Section 641).

Statement of Case.

A statement of the case is contained under heading, "Statement of the Matter Involved" in the foregoing petition, Pages 2 and 3, and will not be repeated here. To fur-

ther clarify the statement especial attention is directed to the following appearing in the record:

(1) Petitioner secured by assignment the rights of J. M. Martin in an oil and gas lease, executed by Lewises, as to 1321 acres of land (R. 64).

(2) Original lessors conveyed prior to 1934 to third parties not interested here approximately an undivided one-third interest in the oil, gas and minerals and the right to receive royalties (but not the right to receive rentals or bonuses from future leases), as to the lands leased to Martin (R. 64).

(3) Petitioner operated its leasehold estate, drilling wells and producing and selling oil and gas (R. 61).

(4) April 17, 1934, petitioner acquired by deed from Lewis, et al. the fee title to the land and all remaining lessor interests still attached thereto in the minerals (R. 57). Feb. 1, 1935 petitioner contracted to dispose of its leasehold interest, and did dispose of it to International Petroleum Corporation for $365,000.00, $60,000.00 of which was for personal property, leasehold equipment, and fixtures, and so specified in the contract (R. 57). Petitioner concedes $2,650.00 of such $305,000.00 is not depletable.

(5) Petitioner has received out of production by its assignee, as its pro rata share of oil and gas produced from the leasehold assigned to International Petroleum Corporation since such assignment, a total of $97,858.64 through October sales 1939 (R. 60).

(6) Petitioner anticipated a large development of the property by its assignee, which expectation entered into the consideration for the transaction, the directors feeling they were selling the leasehold at less value than it had, but expecting to be recompensed out of its reserved interest by increased production (R. 31 and R. 61, 62).

(7) Petitioner had a capital investment in the oil and gas in place, and after the transaction with International Petroleum Corporation still had a capital investment in the oil and gas in place, and its assignee was obligated by privity of estate to pay it a pro rata share out of every barrel of oil produced (R. 64 (b), 64 (e), 64 (g)).

Specification of Errors.

I.

The Honorable Circuit Court of Appeals for the Fifth Circuit erred in denying petitioner percentage depletion on $302,350.00 of a $305,000.00 cash payment received by petitioner for assignment of its working interest in an oil and gas property, and such decision is contrary to the weight of authority.

II.

The Honorable Circuit Court of Appeals for the Fifth Circuit erred in holding that petitioner, "after selling outright for money its lease interest, still had an interest in the oil reserve as the successor in title of the lessor, but that is not the same thing as retaining a royalty in the transfer," because by acceptance of the assignment, by reason of privity of estate between lessors' assigns and lessee's assigns, petitioner's assignee was contractually bound to pay petitioner a share out of every barrel of oil produced from the lease, and petitioner secured by a form of legal relationship income derived from the extraction of oil in the form of additional or advance royalty on anticipated production, and such decision is contrary to the weight of authority.

III.

The Honorable Circuit Court of Appeals erred in holding that petitioner was not entitled to percentage depletion and

that "there is no room to say that the money in this transaction was paid as advance royalty and hence is depletable income arising from the operation of the oil wells," because such decision incorrectly interprets Section 23 (m) Revenue Act of 1934, (Sec. 23 (m), Internal Revenue Code, 1939), and Regulations 86, Art. 23 (m)-10, and is contrary to the weight of authority.

IV.

The Honorable Circuit Court of Appeals erred in failing to give effect to a rule of property established by the courts of Texas, holding that the reversionary interest in the 7/8ths minerals covered by an oil and gas lease is a taxable interest in land. The decision ignores the fact that petitioner had and retained an interest in the 7/8ths mineral estate conveyed to International Petroleum Corporation, to-wit, the reversion, regardless of whether or not petitioner's total interests in the oil and gas merged so as to make its transaction analogous to execution of a lease, and such decision is contrary to the weight of authority.

ARGUMENT.

Point I.

Summary:

The Circuit Court of Appeals erred in holding that petitioner was not entitled to take percentage depletion on the cash sum received by it for transfer of an interest in oil and gas property.

Referable to the Question—and Reason I, II, III, IV, and V in Petition and Specifications of error I, II, III, and IV in Brief:

For brevity and to avoid repetitions, the argument will proceed under Specification I, II, and III combined under this point.

Argument and Authorities Under Point I:

The relevant portion of the statutes involved herein, being Section 23 (m), Revenue Act of 1934, (Sec. 23 (m), Internal Revenue Code, 1939), are lengthy and are set out in the appendix hereto.

The decision and holding of the Circuit Court of Appeals was to the effect that petitioner, owner of the 7/8ths leasehold, and owner of the reversion thereof, and also owner of a portion of the royalty reserved in the lease assigned, and of the entire fee in the land, did not have such an interest after assignment of the lease only as would entitle it to deplete the cash consideration as a bonus or advance payment of royalty.

This Court in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 53 S. Ct. 161, said:

> "We think it no longer open to doubt that when the execution of an oil and gas lease is followed by production of oil, the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Sec. 234. See *Burnet* v. *Harmel, supra.* This is obvious where royalties are insufficient to return the capital investment. A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, making no provision for a reasonably anticipated production of oil on the leased premises, would deny the 'reasonable allowance for depletion' which the statute provides."

The text is amply supported by the authorities therein cited, and it is significant that the court used the language, "making no provision for a reasonably anticipated production of oil on the leased premises." The object of a lessor is to procure income from the removal of gas and oil from his premises. Petitioner had the same object and not only

a reasonable anticipation of production, but had by its own development made such anticipation a practical certainty, and it sought to have its land operated to produce such income by one more able to carry out larger development than it could do, and the one-eighth royalty provided in the lease was not a sufficient recompense to justify granting such operating rights to another, so it demanded and received an additional advance royalty in anticipation of such production, and its deal with International Petroleum Corporation secured to it, the just value of the use of its property which the fixing of the one-eighth royalty in the lease by Lewis was not adapted to give it, as said in *Works* v. *United States ex rel. Mosier,* 261 U. S. 252:

> "The bonus, which was the result of bidding for desirable oil and gas leases, secured for the members of the Osage Tribe the just value of the use of their property which the fixing of royalties in advance by the President was not adapted to give them. It was, in effect, a supplement to the royalties already determined. It was really a part of the royalty or rental in a lump sum or down payment. We do not see how it can be classified as anything else. It *was income from the use of the mineral resources of the land.* Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the product of the mine."

In *Palmer* v. *Bender,* 287 U. S. 551, 53 S. Ct. 225, the Court said:

> "Both courts below followed the earlier decisions of the Court of Appeals with respect to the two assignments involved here and held that they were assignments of leases for stipulated considerations of bonuses paid and royalties to be received. The Government rested its case on this conclusion. It conceded that if

> any reversionary interest, according to common law, however small, had been retained in the leased land * * * the petitioner would be entitled to depletion as claimed."

Here, petitioner had a reversionary interest in the land which it retained. Also, its assignee, by virtue of privity of estate, was obligated by acceptance of the assignment, to pay to petitioner as lessors' assignee, the share of oil and gas production provided in the lease. (*Spencer's Case,* 1538, 5 Coke, 16a; *Pierce Fordyce Oil Ass'n* v. *Woodrum,* 188 S. W. 245; 3 Summers Oil & Gas, Permanent Edition 299, Sec. 553.)

In *Palmer* v. *Bender, supra,* the Court further stated:

> "The allowance to the taxpayer is not restricted by the words of the statute to cases of any particular class or to any special form of legal interest in the oil well. * * *. *The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired by investment, any interest in the oil in place, and secures, by any form of relationship, income derived from the extraction of the oil, to which he must look for a return of this capital.* That the allowance for depletion is not made dependent upon the particular form of the taxpayer's interest in the property to be depleted was recognized by this court in *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364 * * *. Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. IT IS ENOUGH IF BY VIRTUE OF THE LEASING TRANSACTION HE HAS RETAINED A RIGHT TO SHARE IN THE OIL PRODUCED. IF SO HE HAS AN ECONOMIC INTEREST IN THE OIL, IN PLACE, WHICH IS DEPLETED BY PRODUCTION. Thus we have recently held that *the lessor is entitled to a depletion allowance*

on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. * * *. Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees were entitled to share in the oil produced. Production and sale of the oil produced would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."

* * * * * * *

"The statute makes effective the legislative policy, favoring the discoverer of oil, by valuing his capital investment for purposes of depletion at the date of the discovery rather than at its original cost. *The benefit of it accrues to the discoverer* IF HE OPERATES THE WELL AS OWNER OR LESSEE, OR IF HE LEASES IT TO ANOTHER. IT WOULD BE AN ANOMOLY IF THAT POLICY WERE TO BE DEFEATED AND ALL BENEFIT OF THE DEPLETION ALLOWANCE WITHHELD BECAUSE HE CHOSE TO SECURE THE RETURN OF HIS CAPITAL INVESTMENT BY STIPULATING FOR A SHARE OF THE OIL PRODUCED FROM THE DISCOVERED WELL THROUGH OPERATION BY ANOTHER.

"The bonus received by the Smitherman partnership *was a return pro tanto of the petitioner's* CAPITAL INVESTMENT IN THE OIL, AN ANTICIPATION

OF ITS EXTRACTION, RESULTING IN A CORRESPONDING DIMINUTION OF THE UNIT DEPLETION ALLOWANCE UPON THE ROYALTY OIL AS PRODUCED."

The decision of the Circuit Court in effect restricting such depletion allowance on assignment of a lease to reservation of over-riding royalty, excluding consideration of the peculiar circumstances of this case and giving no effect to the decisions of the Supreme Court to the effect that:

> "The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to—(the Smitherman partnership in that case—petitioner here).
>
> "Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case." *Palmer* v. *Bender, supra.*

and as said in *Anderson-Prichard* v. *Helvering,* 60 S. Ct. 952, with respect to the character of instrument involved in *Thomas* v. *Perkins,* 301 U. S. 655:

> "The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type. See Palmer *v.* Bender, 287 U. S. 551, 555-557; Burnet *v.* Harmel, 287 U. S. 103, 111."

probably conflicts with the applicable principles set forth there.

In a solicitor's memorandum it was held that where a corporation which owned a coal leasehold acquired the remainder interest, it should capitalize that portion of the leasehold cost allocable to that portion of the original term

of the lease unexpired at the date of the acquisition of the remainder. The cost of the coal lands was the amount so capitalized plus the price paid for the remainder (Sol. Mem. 2931, IV-I C. B. 33, modifying Comm. Rec. 3240, II-2 C. B. 108), and such memorandum is an indication of the department's opinion as to what would constitute petitioner's capital investment in this case. See also *Henry Boos,* 30 B. T. A. 882.

The cases cited by the Circuit Court of Appeals, to-wit, *Commissioner* v. *Fleming,* 82 F. (2) 324; *Laird* v. *Commissioner,* 97 F. (2) 730; *Hammond* v. *Commissioner,* 106 F. (2) 420; *Helvering* v. *Elbe Oil Land Development Co.,* 303 U. S. 372, 58 S. Ct. 621, 82 L. Ed. 904; *Anderson* v. *Helvering,* 310 U. S. 404, 60 S. Ct. 952, 84 L. Ed. 1277, were cases where lessees disposed of all their interest in the oil and gas in place, leaving nothing to be depleted, but they re-assert the applicable principles contained in *Palmer* v. *Bender, supra,* and in other Supreme Court cases, which principles applied to the facts here disclose a conflict between such cases and the decision of the Circuit Court in this case, the conflict appearing not so much in failure to recognize the right to depletion where a depletable interest is retained, as in determination of whether under the peculiar conditions of each case there is such a retained interest, and in failing to apply the correct reasoning and broad policy set forth in such decisions in determining whether such interest is retained.

To illustrate, the ruling of the Board of Tax Appeals that the taxpayer had no depletable interest, in *Bankline Oil Company, Petitioner,* v. *Commissioner of Internal Revenue, Respondent* (33 B. T. A. 910) was reversed by the Circuit Court of Appeals for the Ninth Circuit (90 F. (2) 899) and because of an asserted conflict with the principles applicable under the decision of the Supreme Court, this

court granted certiorari. There the question was whether a processor of wet gas who claimed right by reason of its contracts to depletion of 27½ per cent of the difference between the price which it paid for wet gas and its fair market value at the mouth of the wells had a depletable interest. The Circuit Court of Appeals was of the opinion that respondent oil company had acquired an economic interest in the wet gas in place, but this Court held it had only an economic advantage; but because of the probable conflict with other cases on the question of retention of depletable interest certiorari was granted.

Again in *Helvering* v. *Elbe Land Development Co.*, 303 U. S. 372, likewise from the Ninth Circuit, there was also the conflict as to whether under the facts there was a retained interest depletable, and this Court granted certiorari, as is also the case in *Helvering* v. *O'Donnell*, 303 U. S. 370, 58 S. Ct. 619, where depletion on payments for stock from oil profits was involved, and on the issues in all these cases, the conflict arose from determination of the question of whether the facts disclosed a retention of a depletable interest. Petitioner here presents a probable conflict with the applicable decision of the Supreme Court on the same legal question, that is, under the peculiar conditions of its case petitioner claims retention of a depletable interest, and that the decision of the Circuit Court of Appeals that it did not retain such interest, probably conflicts with the applicable decisions of this Court heretofore cited.

Point II.

Summary:

The Circuit Court of Appeals erred in failing to give effect to a local rule of property which holds a reversionary interest in an oil and gas leasehold estate is a taxable interest in land.

Referable to the Question, and Reason V in the Petition, and Specification of Error IV in Brief:

Argument and Authorities under Point II:

The decision and holding of the Circuit Court of Appeals was to the effect that petitioner did not retain a depletable interest in the property sold. The petitioner owned ⅔rds of the reversion in the leasehold conveyed by the assignment, and retained same.

No doubt such "possibility of reverter" or inchoate right to the reversion of the working interest in the minerals is an interest in land in Texas. *Caruthers* v. *Leonard, Com. App.*, 254 S. W. 779, 782. Such a right can be deeded by its owner as an interest separate and apart from the surface rights or royalty. *Id.* Such inchoate reversionary right is conveyed by a general warranty deed to the land to which it is attached, even though it is not therein referred to *Robinson* v. *Jacobs*, 113 Tex. 231, 254 S. W. 309.

Petitioner, owning such interest in the working interest transferred, it was depletable, and the judgment of the Circuit Court in refusing depletion probably conflicts with the decision of this Court in *Palmer* v. *Bender*, and decides an important question of local law in a way probably in conflict with applicable local decisions.

Conclusion.

It is respectfully submitted that by reason of the importance to the oil industry as a whole of having the opinions of the courts in harmony with respect to the character of retained interest in minerals which will give character to a cash payment as a bonus or advance royalty, and the probable conflict of the decision of the Circuit Court in this case with the applicable decisions of the Supreme Court determining such question under the peculiar cir-

cumstances of this case, which presents a situation demanding determination of whether such interest was retained under a fact situation never before directly passed upon by the Supreme Court, but which should be determined, the Supreme Court of the United States should exercise its jurisdiction and grant a writ of certiorari in this cause to the United States Circuit Court of Appeals for the Fifth Circuit to review the judgment of that court entered on the 8th day of April, 1941, and that upon such review the judgment of said court be reversed and petitioner be allowed depletion as claimed.

Respectfully submitted,

WALTER G. RUSSELL,
ROSS M. LAMBDIN,
GEO. S. MCCARTHY,
All of Amarillo, Texas,
Attorneys for Petitioner.

APPENDIX.

Statutes.

Section 23 (m), Revenue Act of 1934 (Sec. 23 (m), Internal Revenue Code, 1939), provides:

"In computing net income there shall be allowed as deductions:

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, *according to the peculiar conditions in each case;* such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion allowable under this subsection, see Section 114(b) (3), and (4).)

(n) Basis for depreciation and depletion.—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall

be as provided in Section 114. Section 114 (b) (3), Revenue Act of 1934 (Section 114 (b) (3), Internal Revenue Code, 1939), provides:

(b) Basis for depletion.

* * * * * * *

(3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under Section 23 (m) *shall be* 27½ *percentum of the gross income from the property during the taxable year,* excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

Regulations.

The provisions of the regulations applicable to this case will be found at Article 23 (m)-1, 23 (m)-4, 23 (m)-10 and 114-1 of Regulations 86.

Regulation 86, Art. 23 (m)-1. Depletion of mines, oil and gas wells and other natural deposits, and timber; depreciation of improvements.—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvement. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under these provisions of the Act the *owner of an interest in mineral deposits, mineral properties* or timber, is allowed annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property as provided in Section 113, plus, in either case, subsequent allowable capital additions

(see Article 23 (m)-15 and 23 (m)-16) with the following exceptions and qualifications:

(1) In the case of coal mines * * * and oil and gas wells the aggregate annual allowable deductions may, because of percentage depletion, ultimately exceed the cost or other basis.

* * * * * * *

(3) In the case of mines other than metal, coal or sulphur mines the aggregate annual deductions may exceed the cost or other basis because of the discovery provision.

Operating lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a mining or oil or gas corporation is not allowed such deductions with respect to the property of the corporation.

* * * * * * *

When used in these Articles 23 (m)-1 to 23(m)-28 covering depletion and depreciation:

(b) A *"mineral property" is the mineral deposit,* the development and plant necessary to its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(j) "The property", as used in Section 114 (b) (2), (3), and (4) and Articles 23 (m)-1 to 23 (m)-19 inclusive, means the interest owned by the taxpayer, freehold or leasehold, in any mineral property. The taxpayer's interest in each separate mineral property is a separate property, but, *where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property"* provided such treatment is consistently followed.

Art. 23 (m)-4. Computation of depletion based on a percentage of income in the case of oil and gas wells.—Under Section 114 (b) (3), in the case of oil and gas wells, a tax-

payer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer" (computed without allowance for depletion) from the property see Article 23 (m)-1, (g) and (h)). In no case shall the deduction computed under this paragraph be less than it would be if computed upon the cost or other basis of the property provided in Section 113.

Art. 23 (m)-10. Depletion-Adjustments of accounts based on bonus or advanced royalty.—

(d) In lieu of the treatment provided in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ per cent of the amount thereof; * * *; but the deduction shall not in any case exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (All italicizing of above statutory provisions our own.)

FILED
NOV 12 1941
CHARLES ELMORE CROP
CLERK

NO. 136

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

BADGER OIL COMPANY, Petitioner

vs.

GUY T. HELVERING
Commissioner of Internal Revenue

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit

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MOTION FOR REHEARING TO RECONSIDER REFUSAL to GRANT WRIT of CERTIORARI AND FOR GRANTING OF WRIT OF CERTIORARI

WALTER G. RUSSELL,
ROSS M. LAMBDIN,
GEO. S. McCARTHY,
Counsel for Petitioner.

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TO THE HONORABLE, THE CHIEF JUSTICE, AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Comes now the Badger Oil Company, having heretofore on to-wit the 7th day of November, 1941, been granted an extension of time to November 14, 1941, within which to file this motion, and presents its motion for a rehearing by this Honorable Court to reconsider its action of October 13, 1941, on which

date this Honorable Court denied the issuance of its writ of certiorari as prayed for by Petitioner.

In support of which motion Petitioner submits the following:

1. The general importance of the issue to the oil industry is reflected by the fact that at the present term of the Supreme Court several cases were presented involving similar fact situations and involving the determination of whether taxpayer, as in Petitioner's case, was entitled to deduct percentage depletion on cash sums received for the transfer of oil property as for bonus or advance royalty payments. Attention is called to Roeser & Pendleton, Inc. vs. Commissioner, writ of certiorari denied October 13, the same day petitioner's writ was denied, in which a taxpayer was asserting a similar application of the law relating to allowance of depletion; Marrs McLean, denied by this Honorable Court on October 20, where taxpayer was asserting he was not entitled to depletion, but had made an outright sale reserving no economic interest, and the Commissioner was taking the position that the case was a "Palmer vs. Bender" case and Petitioner was entitled to deplete the cash bonus received for the sale of oil properties, while in the Badger, or instant case, the Petitioner was maintaining its right to deplete a cash sum so received and the Commissioner was denying the right, and writ of certiorari was denied in both cases. We are also informed of the case of Rialto Mining Corporation vs. Commissioner, an Oklahoma case, on a similar issue, the Commissioner being appellant, but withholding appeal until final determination of the Badger Oil Company case. All of which references are submitted as indicating the general importance of the question involved and the uncertainty evidently existing as to proper application of the law to the facts.

In this respect Petitioner is informed and believes that the taxpayers in the Roeser, Inc., case and the Marrs McLean case, both decided at this term of court and which involve conflicting interpretations of the same or similar issues, are filing motions for rehearing to reconsider refusal of the court to grant the writ of certiorari, and in part are basing their respective motions on the importance of the question as exemplified by the cases which have arisen and will unquestionably arise in the industry until the question is set at rest by the decision of this Honorable Court on its merits.

2. The matter at issue is one involving an industry of great importance and which should have for its encouragement in producing the present large requirements and anticipated increased demands a settled policy of the law to guide its future investments and operations.

3. The denial of review in cases involving apparently conflicting decisions on the same or similar issues leaves no precedent to guide the taxpayer nor the Treasury Department, not being a determination of the issue which can serve as a precedent.

4. Numerous cases, as demonstrated, have already arisen involving the issue, and it will become increasingly important that there be a settled decision by the highest tribunal to guide large operators who will in the future take over the operations of smaller owners in order to develop petroleum products more abundantly and relieve threatened or existing shortages.

WHEREFORE, because of the importance of the issue involved to the oil industry as a whole and the necessity for settled decisions of this highest court to

guide taxpayer and Government, the Petitioner respectfully urges that this Honorable Court reconsider its determination heretofore reached herein refusing the grant of certiorari, and that upon a reconsideration of the cases and of the briefs and petitions whose contents fully set out the position of the litigants, that the writ of certiorari be granted to the end that the law may be settled and the case heard on its merits.

Respectfully submitted,

WALTER G. RUSSELL,
ROSS M. LAMBDIN,
GEO. S. McCARTHY,
Counsel for Petitioner.

I,_____counsel for appellant above named, herewith certify that the foregoing petition for a rehearing is presented in good faith and not for delay.

_____
Counsel for Appellant.

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 136

BADGER OIL COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 27–39) is reported in 42 B. T. A. 521. The opinion of the United States Circuit Court of Appeals for the Fifth Circuit (R. 143–148) is reported in 118 F. (2d) 791.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 8, 1941 (R. 149). A petition for rehearing, filed April 28, 1941 (R. 150), was denied on May 10, 1941 (R. 157). The petition for

a writ of certiorari was filed on June 6, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer acquired by assignment an oil and gas lease. Subsequently, the taxpayer acquired the fee title to the property and approximately two-thirds of the lessor's royalty interest. In the taxable year, the taxpayer reassigned the lease for a cash consideration. The question presented is whether this cash consideration is subject to percentage depletion under Section 114 of the Revenue Act of 1934.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * (U. S. C., Title 26, Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * * (U. S. C., Title 26, Sec. 114.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Art. 23 (m)–4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)–1 (*g*) and (*h*).) In no case shall the deduction computed

under this paragraph be less than it would be if computed upon the cost or other basis of the property provided in section 113.

Art. 114–1. *Basis for allowance of depreciation and depletion.*—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, except as provided in article 23 (m)–3, relating to depletion based on discovery value, in article 23 (m)–4, relating to percentage depletion in the case of oil and gas wells, and in article 23 (m)–5, relating to percentage depletion in the case of coal mines, metal mines, and sulphur mines or deposits.

STATEMENT

In 1921 T. D. Lewis and his wife, Vida M. Lewis, executed an oil and gas lease to J. B. Martin, covering 2,269.76 acres of land in Hutchinson County, Texas, and 640 acres in Carson County, Texas. The lease reserved to the lessors a royalty of one-eighth of oil and gas produced (R. 28).

In 1926 the Badger Oil Company acquired by assignment the rights of J. B. Martin in 1,321 acres of the original lease, of which 250 acres were in Carson County, and the remainder in Hutchinson County (R. 28).

In 1928 the taxpayer assigned to the McIllroy Oil Company 120 acres of the leasehold in Carson County. The consideration for that assignment was the agreement by the McIllroy Oil Company to pay to taxpayer $18,000 out of oil and/or gas, if and when produced and saved from the land (R. 28).

In 1930 the taxpayer acquired by assignment from Paul and Weatherly the lease on 126 additional acres in Hutchinson County out of the original lease from T. D. Lewis and wife to J. B. Martin (R. 29).

At various times prior to April 17, 1934, T. D. Lewis and wife conveyed to persons not involved herein approximately an undivided one-third interest in the oil, gas, and minerals and the right to receive royalties (but not the right to receive rentals or bonuses from future leases), as to the lands leased to Martin and subject to the lease to him (R. 29).

On April 17, 1934, Vida M. Lewis and the heirs of T. D. Lewis, for a consideration of $40,000, executed to the taxpayer a warranty deed to all of the lands in Hutchinson County which had been covered by the lease to J. B. Martin. The deed did not cover the lands in Carson County, which were subject to the lease to Martin. In addition to the usual terms of conveyance, the deed contained the following language: "It is our intention to convey all of our interest of every kind and nature what-

soever in and to the above lands, including all of our interest in and to the minerals, rents, and royalties therein" (R. 29).

On February 1, 1935, the taxpayer and the International Petroleum Company executed a contract providing for the sale by taxpayer to International of (1) the leasehold acquired by the taxpayer in 1926, except the 120 acres conveyed to McIllroy Oil Company; (2) the unpaid portion of the $18,000 oil payment payable to the taxpayer from the McIllroy Oil Company, and (3) the lease on 126 acres in Hutchinson County acquired by the taxpayer in 1930 from Paul and Weatherly. The contract provided, *inter alia,* for the execution and delivery by the taxpayer of: (a) An assignment of the oil and gas lease to Martin so far as assigned to the taxpayer and covering lands in Hutchinson and Carson Counties, Texas, except the 120 acres which had in 1928 been assigned to the McIllroy Oil Company; (b) the unpaid portion of the $18,000 oil payment; (c) a bill of sale from the taxpayer to International covering personal property in Hutchinson and Carson Counties, Texas, having connection with the leases assigned from taxpayer to International (R. 29–30).

The contract between the taxpayer and International (R. 103) refers to the taxpayer as "Seller" and International as "Buyer." This contract provided as follows (R. 103):

> Seller agrees to sell, deliver, assign and convey and Buyer agrees to buy for the con-

> sideration, upon the terms and subject to the provisions hereinafter stated, the following described real and personal property * * *.

The contract recited (R. 105) that the consideration agreed to be paid for the oil payment and the oil and gas leasehold was the sum of $305,000, and that the consideration agreed to be paid and received for the personal property was the sum of $60,000, which total consideration of $365,000 was to be paid in cash to the extent of $200,000 and the balance of $165,000 in notes of the buyer to be secured by a deed of trust upon the assigned property. The entire recited consideration of $365,000 was actually paid in cash during the taxable year (R. 38).

Before the Board, the taxpayer claimed depletion at the rate of 27½% upon $305,000. In the court below, the taxpayer conceded that as to the 130-acre lease in Carson County, of $650 value, and as to the unpaid portion of an oil payment of $2,000 value, it could not maintain its position. The sole question before the court below was whether the Board correctly denied the taxpayer a depletion allowance with respect to its resale of the 1,321-acre lease (the "Martin" lease) to the McIllroy Oil Company in 1928.

The court below (R. 143–148) approved the action of the Board in treating the cash payment of $305,000 as purchase money rather than as advance royalty; and, therefore, denied the tax-

payer any depletion deduction with respect to that payment.

ARGUMENT

The taxpayer was the owner of the "Martin" lease. It sold the lease for a cash consideration, reserving in the contract of sale no interest whatever in the leasehold. The proceeds of that sale therefore represent the consideration derived from the disposition of a capital asset rather than "royalties" or the like against which depletion is allowable. *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372; *Anderson* v. *Helvering*, 310 U. S. 404. The court below followed its earlier decision in *Commissioner* v. *Fleming*, 82 F. (2d) 324, which was apparently approved by this Court in the *Elbe Oil* decision. See 303 U. S. at 374.

Petitioner's sole attempt to escape the consequences of this result rests upon the fact that it had meanwhile acquired various reversionary interests in the oil property. But it had not acquired the entire reversion, for one-third of the royalties originally reserved by the lessor continued to remain outstanding in adverse hands. Accordingly, petitioner had two distinct interests in the property: one, a leasehold, and the other, a portion of the reversion. And the fact that it owned a portion of the reversion, entirely separate and apart from the leasehold, cannot render inapplicable the principles recognized in the foregoing decisions.

The decision below is not in conflict with the numerous decisions of this Court cited by petitioner (Pet. 5). *Palmer* v. *Bender*, 287 U. S. 551, is perhaps the closest of the cases cited, and it involved a lessee which transferred a portion of its leasehold for certain fixed amounts as well as a one-eighth royalty interest in all the oil to be produced. This Court held that in those circumstances, the lessee-transferror still retained an interest in the very portion of the leasehold transferred, and that the payments received were not to be treated as payments for the sale of a capital asset. Similarly here, to the extent that the taxpayer stepped into the shoes of the original lessor and thus received royalties from the new assignee, those royalties would form the basis for a depletion allowance. But the payments here involved were not of that type: The taxpayer, *as lessee,* sold the lease outright. It is merely fortuitous that the taxpayer also had another and wholly independent interest in the reversion.

The further assertion by the petitioner (Pet. 12) that the decision below is probably in conflict with applicable local law, as to rules of property, furnishes no basis for the issuance of the writ. Under the facts of this case, the lease in question could not merge with the subsequently acquired fee because of the outstanding adverse interest in the lease and because of the obvious intention on the part of the taxpayer that there should be no

merger. The taxpayer's interest as lessee under this lease was the property with which we are here concerned and its entire interest as such lessee was sold for a cash consideration, which had no relation to oil to be produced and accordingly furnished no basis for the use of the percentage depletion deduction.

CONCLUSION

The decision below is correct. There are no conflicts. The petition should be denied.

Respectfully submitted.

CHARLES FAHY,
Acting Solicitor General.
SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
J. LOUIS MONARCH,
JOSEPH M. JONES,
Special Assistants to the Attorney General.

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